

MEMORANDUM OF LAW

DATE: November 24, 1993

TO: Larry Grissom, Retirement Administrator

FROM: City Attorney

SUBJECT: Waiver of Interest on Purchase of Service Credit

You have asked for a written opinion on whether or not the waiver of interest charges on the purchase of service credits for a three year period would constitute an improper gift of public funds. If it is not a gift of public funds, you would like advice on establishing a time frame for eligibility and the type of purchases where this waiver would be applicable.

This memorandum analyzes those issues, and also analyzes the Board's fiduciary duties with respect to the waiver of interest, as that issue is closely related to the concerns expressed by the Board.

BACKGROUND

At the October 16, 1992, meeting of the Board of Administration, the Board unanimously approved several staff recommendations regarding purchases of service credit, including a recommendation to waive interest for the period of July 1, 1990 through June 30, 1993, subject to an assurance that the waiver of interest would not be a gift of public funds.

Before being amended on July 12, 1993, former San Diego Municipal Code ("SDMC") sections 24.0312 and 24.1006 required members to purchase service credits within one year of becoming a member. There are members who joined the System before that date and sought to purchase service credit, but were denied that opportunity because no cost estimates were available.

Staff recommended that interest be waived because the delay in processing purchases of service credit during that period was due to the inability of the Retirement System to provide cost estimates, not to any action or inaction by the members.

Under the amended ordinance, which deleted the one year limitation for purchasing service credits, these members are now able to purchase service credits. SDMC sections 24.1303, 24.1308.

ANALYSIS

Pension Benefits Must be Liberally Construed

It is well-settled that pension laws must be liberally construed to protect pensioners from economic insecurity and to provide all intended benefits to members.

Pension legislation must be liberally construed and applied to the end that the beneficent results of such legislation may be achieved. Pension provisions in our law are founded upon sound public policy and with the objects of protecting, in a proper case, the pensioner and his dependents against economic insecurity. In order to confer the benefits intended, such legislation should be applied fairly and broadly.

Lundak v. Board of Retirement, 142 Cal. App. 3d 1040, 1043 (1983) (citations omitted).

The Board Has the Power to Determine the Amount of Interest

The City Council has delegated to the San Diego City Employees' Retirement System ("SDCERS") Board of Administration the power and responsibility to determine the amount to be paid to purchase service credit in most instances. SDMC section 24.1310 provides: "To purchase Service credit, a Member must elect to pay and thereafter pay, . . . into the retirement fund an amount, including interest, determined by the Board." (Emphasis added.)

In a few instances, such as purchase of the probationary period service credits and repayment of an amount previously refunded, the City Council has specified the rate of interest. SDMC sections 24.1302, 24.1306. Those areas are not implicated in this discussion. In other cases, the Board does have the discretion to determine the amount due to purchase service credit.

Public Funds May Be Spent Only for a Public Purpose

San Diego City Charter ("Charter") section 93, which prohibits The City of San Diego from giving or lending its credit to aid any individual, association or corporation, except for suitable provisions to aid the poor, has been construed to bar the gift of public funds to individuals. The California Constitution has a similar prohibition against the gift of state funds by the Legislature. California Constitution Article XVI, Section 6. Although this Constitutional prohibition does not apply to charter cities, Tevis v. City & County of San Francisco, 43 Cal. 2d 190, 197 (1954), the cases interpreting it are

instructive.

Public funds may be spent only for a public purpose. It is for the legislative or appropriating body to determine what is a public purpose, and courts grant great deference and discretion to the appropriating board or body. *Atlantic Richfield Co. v. County of Los Angeles*, 129 Cal. App. 3d 287, 298 (1982). As long as there is a reasonable basis for the Retirement Board's action in waiving interest, it will not be second-guessed by the courts.

Funds are spent for a public purpose where there is a direct benefit of a reasonably general character to a significant portion of the public, regardless of whether or not there is an incidental benefit to individuals. See 15 McQuillin, *Municipal Corporations* Section 39.19 (rev. 3d ed. 1985). An expenditure of public funds for a public purpose, notwithstanding incidental benefits to private persons, does not violate the constitutional prohibition against gifts of public funds. *San Bernardino County Flood Control Dist. v. Grabowski*, 205 Cal. App. 3d 885, 903 (1988).

The Board Has Expressed a Substantial and Reasonable Public Purpose

At the October 12, 1992 meeting, the Board specified a public purpose for waiving three years' worth of interest: it would not be fair to charge interest to those people who would have bought back previous years of service credit during that three-year period, when it was the tardiness of the Board, rather than of the individuals, which delayed the purchase of service credit. The Board felt an obligation to treat its members fairly, to maintain the confidence of its members and to improve the morale of City employees.

In an analogous case, the California Supreme Court ruled that a retroactive pay increase to state employees was not an improper gift of public funds when it was compensating employees who had continued to work through a period of great insecurity. *Jarvis v. Cory*, 28 Cal. 3d 562 (1980). The Legislature had initiated the retroactive pay increase "to ensure the continued recruitment and retention of qualified and competent state employees." The Supreme Court affirmed this as a reasonable and substantial purpose for the expenditure of public funds. *Id.* at 578-579, fn. 10.

The Supreme Court found additional substantial public purposes served by the legislative enactment:

Nor can we doubt that Senate Bill 91 serves the purpose by assuring state employees they will not be abandoned in troubled times, and by

raising salaries to a level more competitive with those in the private sector. (Citation omitted.)

Furthermore, our discussion has revealed at least three other public purposes served: (1) avoidance of legal disputes over colorable equal protection claims, (2) provision of funds to allow salary-setting bodies to fulfill their duties, and (3) resolution of continuing uncertainty about proper salary levels. SB 91 is therefore not a gift of public monies.

Id.

In another case, the Legislature properly decided to provide a minimum of ten percent (10%) interest on the value of land taken by eminent domain, even during those times when the market interest rate is lower than ten percent (10%). *San Bernardino County Flood Dist.*, supra at 903-904. Even though a relatively small number of individuals benefitted from this legislative decision, it was not an improper gift of public funds because it was a reasonable accommodation to property owners whose property was taken by the government.

An Arizona court found that post-retirement benefit increases did not violate an anti-gift clause of the Arizona Constitution because the benefit increases served four public purposes: protecting the economic security of retirees; satisfying the state's moral obligation to ameliorate the effects of inflation; encouraging recruitment of prospective employees; and motivating current employees to stay in the employ of the state. *McClead v. Pima County*, 849 P.2d 1378, 1382 (1992).

In our case, the Board may properly exercise its discretion to waive three years' worth of interest to maintain and boost the confidence and morale of its members. It may assure its members that it will treat them fairly, and ensure the retention of qualified and competent employees. These are substantial and reasonable purposes, which provide a direct benefit of a reasonably general character to a significant portion of the population.

Further, those members who joined SDCERS with the expectation of exercising their option to purchase service credits, but who were precluded from doing so, might have a legal claim against the System. The Board may waive the interest to forestall such a lawsuit.

The Board Should Choose the Types of Purchases for Which to Waive Interest

You requested advice on the type of purchases for which interest should be waived.

Staff has advised that there were three categories of purchases of service credit which were subject to lengthy administrative processing before the July 12, 1993 amendments. These are the purchases of service credit for members who were formerly hourly employees; members of the 1981 Pension Plan purchasing the mandatory one year waiting period required by that plan; and members of the unclassified service.

The public purpose for waiving interest expressed at the October 12, 1992, Board meeting should apply to these three categories.

The Board could also choose to review all types of purchases of service credit available to determine if there is a public purpose to extend the waiver of interest to other sorts of purchases of service credit. This is a policy decision which lies within the sound discretion of the Board.

The Board Must Establish a Time Frame for Eligibility

This waiver of interest could apply to members in the three categories described above who joined before October 12, 1992, or before June 30, 1993, or some other selected date, or it could apply to all of those categories of members who join and purchase service credit for earlier years of service. The minutes for the Board meeting of October 12, 1992, do not set forth the reasons why the period of July 1, 1990 through June 30, 1993, was chosen.

If a waiver of interest is given to persons who joined SDCERS between 1990 and 1993, people who join after 1993 may claim that they are being treated unfairly in that they are not getting a similar incentive to join. Granting the waiver to all such members logically extends the purpose of treating people fairly and maintaining morale and confidence. Especially in light of the seminar which was held on October 28, 1993, some members may claim that it was unfair to grant the waiver of interest only to people who joined before information about the purchase of service credit was generally publicized and disseminated.

If the waiver of interest applies to all members in those categories who purchase previous years of credit, then it will be a significant incentive to people to join SDCERS and purchase all of their years of service. This will increase the participation rate, and the Board may determine that to be a public benefit to the members of SDCERS.

Alternately, the Board may set a date in the future, and

announce to all City employees in the three identified categories that interest will be waived if they join by a certain date in the future. This gives people notice, provides an incentive for a timely decision to join SDCERS, and preserves the resources of SDCERS in the future.

It is up to the Board to decide the time frame for eligibility and express its reasons for the waiver of interest for that time frame.

Breach of Fiduciary Duties

The Board also has fiduciary duties to all members of SDCERS. The Board is obliged to act like a "prudent investor" in preserving the assets of the retirement trust. Probate Code section 16040. Trustees have a general duty to maximize trust assets, consistent with safety and other relevant considerations. *Conservatorship of Pelton*, 132 Cal. App. 3d 496, 501 (1982).

By waiving interest on the purchases of service credit for some members, the Board is foregoing income to the trust account, which harms the interest of other members to some degree. Given the amount at issue, it is a relatively small degree of harm, but should still be considered by the Board in deciding whether or not to waive three years' worth of interest.

In one case, trustees left trust assets in a non-interest bearing account for five years, because they were feuding and could not agree how to invest the funds. Although the trustees were acting in good faith and the trust increased in value during that period, the Court of Appeal found that the trustees breached the prudent investor rule by failing to invest the funds for five years. *Lynch v. John M. Redfield Foundation*, 9 Cal. App. 3d 293, 302 (1970).

The ruling in that case is probably due to the length of time the funds were on deposit without interest, as it is permissible for trusts to hold funds without paying interest in some circumstances, such as when the funds are awaiting investment or distribution, or when they are necessary for the administration of the trust. *Van de Kamp v. Bank of America*, 204 Cal. App. 3d 819, 839 (1988).

In reviewing the Board's fiduciary obligations, the benefits and harms of waiving interest must be weighed with respect to the facts at hand.

The case law on a trustee's discretion to forebear collection of a debt indicates that failure to collect in full by the due date does not necessarily amount to an abuse of the trustee's discretion But

the question is factual; and in some cases indulgence to a debtor may be the prudent course for the creditor.

Estate of Gilliland, 73 Cal. App. 3d 515, 527 (1977)
(emphasis added).

In Gilliland, the trustees decided to collect some notes due to the trust as rapidly as possible without insisting on payment in full, and without obtaining adequate security for the notes, subjecting the trust to a high risk of loss. However, the trustees adopted their strategy to avoid unfavorable tax consequences and other possible jeopardies. The course of action fell within the trustees' discretion, even though other courses of action may have been more prudent.

Here, the City Council has delegated the power to the Board of Administration to determine the amount due for the purchases of service credit, and that discretion encompasses the decision to waive interest for some purchases of service credit. The Board has made a policy decision to waive interest in some cases. Although this action does not maximize the value of the trust, it falls within the discretion of the Board to waive interest to maintain members' confidence in the trust and to forestall litigation. If the Board decides to waive interest for people who join in the future, this may strengthen the arguments for waiving the interest as it will attract more funds into SDCERS and increase its size.

CONCLUSION

It is not a gift of public funds to waive three years' worth of interest for persons who have joined or may in the future join SDCERS. The Board has expressed a reasonable and substantial public purpose for waiving the interest for those people who have been precluded from purchasing previous years of service credit. These same reasons may justify the fiduciary obligations of the Board.

It is well within the Board's discretion to choose the types of purchases for which to waive interest, and to establish a time frame for eligibility. When the Board brings the matter back to discuss the categories of purchases of service credit and the time frame for eligibility, the Board should take the opportunity to spell out its public purposes for waiving interest for those classes of membership.

Please do not hesitate to call if you have any further questions on this subject.

JOHN W. WITT, City Attorney
By

Meagan J. Beale
Deputy City Attorney

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